

## Finance and Banking

### PUBLIC BUDGETARY POLICY ASSOCIATED WITH THE REQUIREMENTS OF THE EUROPEAN UNION INTEGRATION

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**Abstract:** *In the complex process of accession to the European Union and the entry into the Euro Zone, Romania is bound to focus its efforts within finalizing the necessary reforms for fulfilling its commitments. Economic boost, low inflation, budget deficit remained within sustainable and stable exchange rates, all represent priorities and benchmarks of the European construction. In each state, budgetary policy is a result of the elaboration project of several categories of related budgets that make up a system. The budget system is variable depending on the organizational structure of each state: unitary type (France, England, Sweden etc.) and federal type (U.S., Canada, Switzerland, etc.). In Romania the need of resources at the level of society and their possibilities are reflected in the general consolidated budget. The law on Public Finances indicates that the management of public financial resources is carried out by a unified budget system.*

- **Keywords:** *GPD, local budget, state budget, monetary policy, value added tax*

**Jel Classification:** *F - International Economics, F2 - International Factor Movements and International Business, F20 - General*

#### 1. The budget in the context of the European Union enlargement

In the complex process of accession to the European Union and the entry into the Euro Zone, Romania is bound to focus its efforts within finalizing the necessary reforms for fulfilling its commitments. The economic boost, low inflation, budget deficit remained within sustainable and stable exchange rates, all represent

priorities and benchmarks of the European construction. In each state, budgetary policy is a result of the elaboration project of several categories of related budgets that make up a system.

The budget system is variable depending on the organizational structure of each state: unitary type (France, England, Sweden etc.) and federal type (U.S., Canada, Switzerland, etc.). In Romania the need of resources at the level of society and their possibilities are reflected in the general consolidated budget. The law on Public Finances<sup>1</sup> indicates that the management of public financial resources is carried out by a unified budget system that includes:

- The state budget
- The social security budget
- The local budgets
- The budgets of special funds
- The state treasury
- The budgets of other institutions

The general consolidated budget reflects the financial public flows of forming the fiscal and non-fiscal tax revenues and their distribution to destinations in accordance to the social need. The role of the budget is considered an instrument by which it is achieved the granting and the redistribution of resources and it also presents utility in the regulation of economic and social activity.

The state budget in the finance science can be addressed legally and economically. Under its legal appearance the budget is an act that is stipulated and approved the annual revenues and expenditures of the state. State budget provides for and authorizes, from the legislative point of view, the expenditures and state resources, being compulsory and submitted to the Parliament approval. It represents an act of foreseeing the public resources and its use; it is elaborated for a period of one year. The law of the state budget is influenced by political economic and social concepts, specific to each period.

Economic approach concerns the macroeconomic correlation and in particular the connexion between the level and the evolution of the gross domestic product. A certain level of GDP and the extent to which it is assigned to the gross capital formation and consumption, it determines the level of budget indicators and it represents the basis for favourable development of resources in the future.

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<sup>1</sup> The Public Finance Law no. 500 of 11 July 2002 with subsequent amendments, published in the "Monitor Oficial no. 597 of 13 August 2002"

State budget expresses economic relations in cash which rises in the process of the distribution of the gross domestic product, according to the objectives of social, economic and financial policy of each period. These relationships have double meaning: on the one hand, the relationship that mobilizes resources and money, and on the other hand the relationships of distributing these resources.

The relations of resources mobilization are distribution relations of GDP in favour of the state through taxes, fees and contributions, the levies from incomes and transfers attracting the temporary free availability by the intern state loans. It also creates the relations state with foreign countries materialized in external financing.

The budgetary construction on medium term is projected in close connection with the combination of overall macroeconomic policy, that is the monetary policy and the revenue for:

- continuation of the disinflation process and its supplementary reducing;
- maintaining the current account deficit to sustainable limits;
- strengthening the budgetary revenue to cope with expenditures' commitments, that Romania will face in the coming years;
- preparing to insure the necessary conditions to the absorption capacity of structural instruments (structural and cohesion funds) since 2007.

The public policies integrated into a coherent and predictable multiannual scope will take into account the effectiveness of budgetary allocations, which will focus on:

- financing converged policies with those promoted by the European Union - infrastructure, research - development, environment and rural development;
- financing of some public policies of structural adjustment - transport, agriculture industry – for increasing the competitiveness of Romanian economy performance;
- continuing and consolidating the human capital policies - education, health - which will provide premises for achieving sustainable savings in labour domain.

In the domain of public investment it will be stressed upon:

- the development and modernization of transport infrastructure;
- environmental protection by developing the infrastructure in this sector, the investments focus on works of waste water treatment, organic waste storage of waste;

- developing drinking water programs and achieving programs against flooding;
- the investment in agriculture consisting of continuing the works on irrigation systems and improving the soil;
- programs of rehabilitation and consolidation schools and hospitals.

As an official document, the state budget outlines the approved level of expenditures that will make in the near future also the size and revenues that can be to the state.

## **2. The evolution of budget's revenues and expenditures in Romania**

The revenues of the state budget for 2004 are of 288279.8 billion lei, while those in 2005 are of 357366.6 billion as follows:

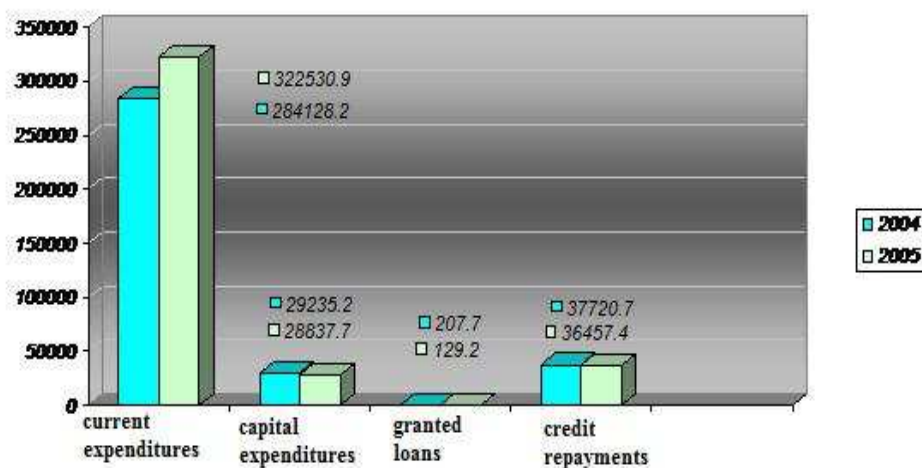
	<b>Billion lei ROL</b>	
	<b>2004</b>	<b>2005</b>
<b>Income – TOTAL</b>	<b>288.279,8</b>	<b>357.366,6</b>
Out of which:		356.158,6
Current income	287.856,8	
Of which		
a) fiscal income s	269.306,8	336.119,6
- direct taxes	58.417,0	75.238,1
Of which:		
Tax on profit	49.210,0	60.710,0
Taxes on wages and income	64.921,0	76.887,0
Quota and deducted amounts on income tax for local budgets (they are subtracted)	- 62.424,0	- 69.718,9
other direct taxes	5.810,0	6.540,0
Contributions	900,0	820,0
Indirect taxes	210.889,8	260.881,5
Of which:		
Value added tax	110.150,8	126.692,5
Levied Value added tax	156.189,0	186.094,0
Deducted amounts from value added tax for local budgets (they are subtracted)	- 46.038,2	- 59.401,5
Excise	68.915,0	97.733,0
Custom duties	13.824,0	16.752,0
Other indirect taxes	18.000,0	19.704,0
b) Non-fiscal revenue	18.550,0	20.039,0
Income from capital	350,0	1.133,0
Recovers from repayment of granted	73,0	75,0

loans

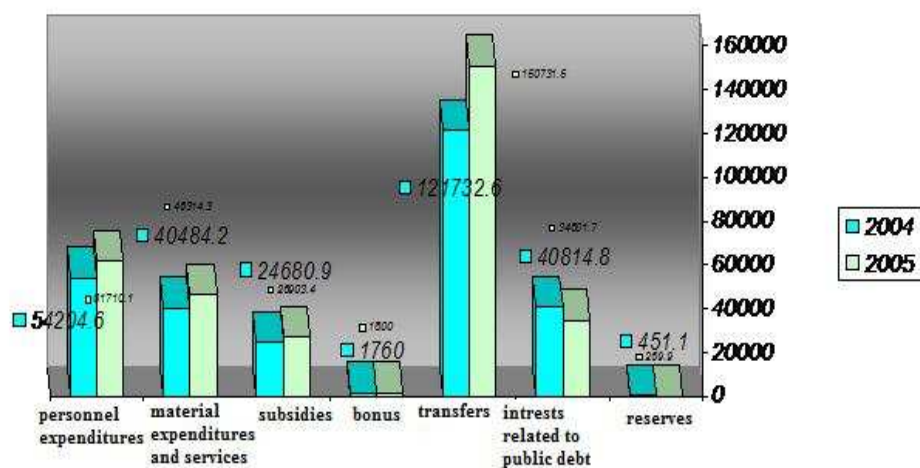
The expenditure of the state budget for 2004 is 351291.8 billion in economic structure and in 2005 is 387955.2 billion, as follows:

	<b>Billion lei ROL</b>	
	<b>2004</b>	<b>2005</b>
<b>Expenditures – TOTAL</b>	351.291,8	387.955,2
Out of which:		
Current expenditures	284.128,2	322.530,9
Of which		
a) personnel expenditures	54.204,6	61.710,1
b) material expenditures and services	40.484,2	46.314,3
c) subsidies	24.680,9	26.903,4
d) bonus	1.760,0	1.800,0
e) transfers	121.732,6	150.731,5
f) interest related to public debt and other expenditures	40.814,8	34.801,7
g) reserves	451,1	269,9
2. Capital expenditures	29.235,2	28.837,7
3. Granted loans	207,7	129,2
4. Credit repayment, interest payment and credit commission	37.720,7	36.457,4
Of which		
a) Repayments of external credits and interest payments and commissions to external credits	37.400,2	36.135,5
- repayments of external credits	26.092,6	24.066,6
- payments of interest and commission	11.307,6	12.068,9
b) Repayments of internal credits and interest payments and commissions	320,5	321,9
- repayments of internal credits	101,7	101,7
- payments of interest and commission		

## Total expenditures – Billions ROL



## Current Expenditures- Billions ROL



### 3. The analysis of budgetary expenditures

A. The value of total expenditures at each of the two years <sup>1</sup>

	Billions Lei ROL	
	2004	2005
Current expenditures	284.128,2	322.530,9
Capital expenditures	29.235,2	28.837,7
Granted loans	207,7	129,2
Credit repayments, interest payments and commissions on credit	<u>37.720,7</u>	<u>36.457,4</u>
<b>Total value on expenditures</b>	<b>351.291,8</b>	<b>387.955,2</b>

A1. The value of current expenditures at each of the two years:

	Billions Lei ROL –	
	2004	2005
Personnel expenditures	= 54.204,6	61.710,1
Material expenditures and services	= 40.484,2	46.314,3
Subsidies	= 24.680,9	26.903,4
Bonus	= 1.760,0	1.800,0
Transfers	= 121.732,6	150.731,5
Interest related to public debt and other expenditures	= 40.814,8	34.801,7
Reserves	= 451,1	269,9
<b>The value of current expenditures</b>	<b>284.128,2</b>	<b>322.530,9</b>

B. The share of each item of expenditure under the structure of the section A in total expenditures in each of the 2 years <sup>2</sup>.

The analysis of expenditure can be made on the basis of their structure on various categories of expenditure, being established the specific share and the

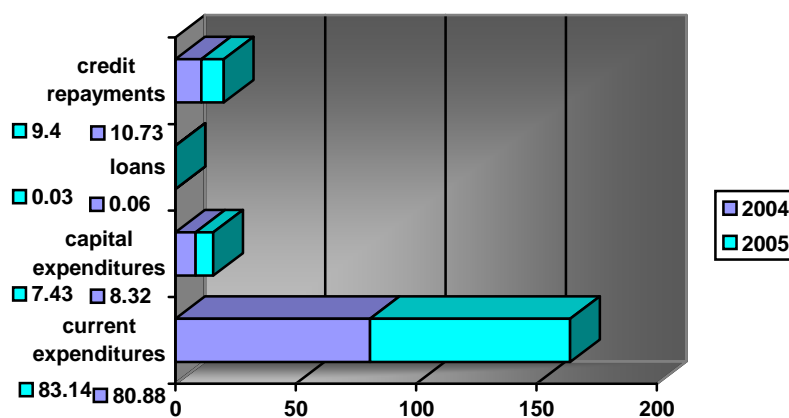
<sup>1</sup> It is determined by summing the current expenditures, granted loans and loan repayments.

<sup>2</sup> The share of each item of expenditure under the structure of the section A in total expenditures at each of the 2 years are calculated on the basis: share = (current expenditures / total expenditures) \* 100

weight of each category of expenditure in total. With the help of shares it will be established the proportion in which the state resources were targeted at specific objectives, changing in dynamics the budgetary options, comparisons between countries with different levels of development.

**Billion lei ROL**

	<b>2004</b>	<b>2005</b>
The share of current expenditure in total expenditures	= 80.88%	83.14%
The share of granted loans in total expenditures	= 8.32%	7.43%
The share of capital expenditure in total expenditures	= 0.06%	0.03%
The share of credit repayments, interest payments and commissions on credit to total expenditures	= 10.73%	9.40%

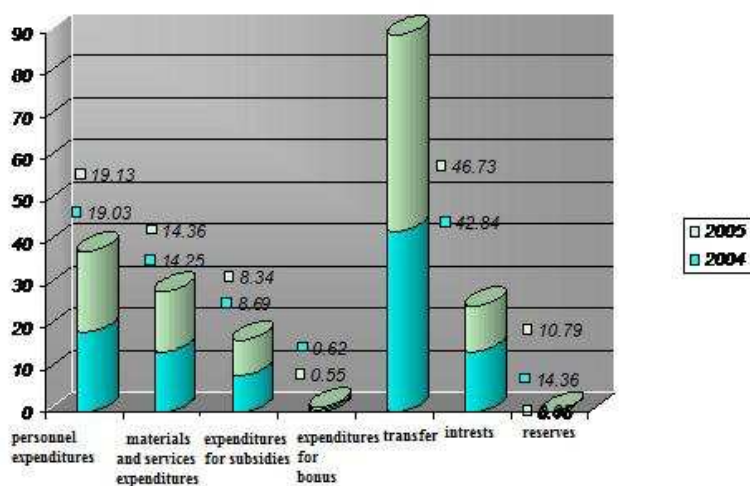


*B1- The share of each item of expenditures under the structure of section A1 in current expenditures at each of the 2 year.*



**Billion lei ROL**

	<b>2004</b>	<b>2005</b>
The share of personnel expenditures in current expenditures	=19,08 %	19,13 %
The share of material expenditures and services	=14,25 %	14,36 %
The share of expenditures for subsidies in current expenditures	=8,69 %	8,34 %
The share of expenditures for bonus in current expenditures	=0,62 %	0,56 %
The share of transfers in current expenditures	=42,84 %	46,73 %
The share of interest related to public debt in current expenditures	=14,36 %	10,79 %
The share of reserves in current expenditures	=0,16 %	0,08 %



*C. Nominal increase in absolute **a** values<sup>1</sup>:*

Total expenditures	= 387.955,2 – 351.291,8	= 36.663,4
Current expenditures	= 322.530,9 – 284.128,2	= 38.402,7
Capital expenditures	= 28.837,7 – 29.235,2	= - 397,5
Granted loans	=129,2 – 207,7	= - 78,5
Credit repayments, interest payments and commissions on credit in total expenditures	= 36.457,4 – 37.720,7	= - <b>1.263,3</b>

*C1- Nominal increase (year 2005 values minus year 2004 values) in **a** absolute values:*

Personnel expenditures	=61.710,1 – 54.204,6	=7.505,5
Material expenditures and services	=46.314,3 – 40.484,2	=5.830,1
Subsidies	=26.903,4 – 24.680,9	=222,5
Bonus	= 1.800,0 – 1.760,1	= 39,9
Transfers	=150.731,5 – 121.732,6	= 28.998,9
Interest related to public debt and other expenditures	=34,801,7 – 40.814,8	=-6.013,1
Reserves	=269,9 – 451,1	=- 181,2

*D. Nominal increase in **a** relative values<sup>2</sup>:*

Total expenditures	= (387.955,2 – 351.291,8)/351.291,8	= 10,44%
Current expenditures	= (322.530,9 – 284.128,2)/284.128,2	= 13,51%
Capital expenditures	= (28.837,7 – 29.235,2)/29.235,2	= - 1,35%

<sup>1</sup> The Nominal increase in absolute value represents current expenditure base expenditure, expressed in current prices and it is calculated based on the relationship between : expenditures in 2005 (current year) minus the expenditures of 2004 (base year).

<sup>2</sup> The nominal increase in relative value is calculated: (2005 values minus values 2004) / values 2004)\*100

Granted loans	$= (129,2 - 207,7)/207,7$	$= -$ 37,79%
Credit repayments, interest payments and commissions on credit in total expenditures	$= (36.457,4 - 37.720,7)/37.720,7$	$= -$ 3,35%

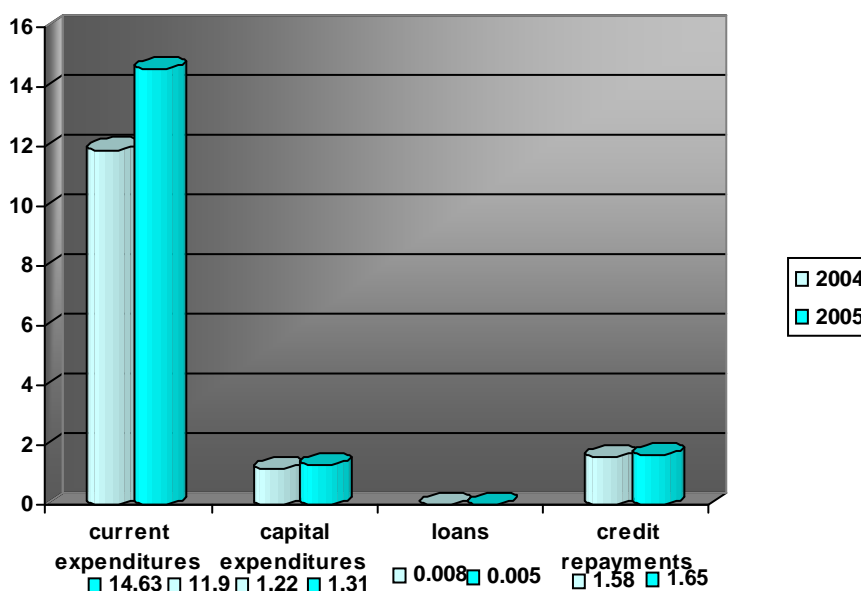
*D1 Nominal increase in relative value (2005 values minus values 2004) / values 2004):*

Personnel expenditures	$= (61.710,1 - 54.204,6)/54.204,6$	$= 13,85\%$
Material expenditures and services	$= (46.314,3 - 40.484,2)/40.484,2$	$= 14,40 \%$
Subsidies	$= (26.903,4 - 24.680,9)/24.680,9$	$= 0,90 \%$
Bonus	$= (1.800,0 - 1.760,1)/1.760,1$	$= 2,27 \%$
Transfers	$= (150.731,5 - 121.732,6)/121.732,6$	$= 23,82\%$
Interest related to public debt and other expenditures	$= (34.801,7 - 40.814,8)/40.814,8$	$= 14,73\%$
Reserves	$= (269,9 - 451,10)/451,1$	$= 40,17\%$

E. *The share of each item of expenditure under the structure of section A in internal gross product*<sup>1</sup>ressed a characterization of the expenditures and their dynamics in a certain period of time. Gross domestic product for 2004 is 2,387,914 billion lei ROL, and for 2005 is 2,494,670 GBP billion Lei.

	Billion lei ROL	
	2004	2005
The share of current expenditures in GDP	$= 11,90$ %	12,93 %
The share of capital expenditures in GDP	$= 1,22 \%$	1.16%
The share of granted loans in GDP	$= 0008\%$	0005%
The share of credit repayments interest payments and credits commissions in GDP	$= 1,58\%$	1,46%

<sup>1</sup> The relation of calculating the share of each expenditure item under the section A in GDP is: (expenditures/GDP)\*100



E1. The share of each item of expenditure under the section

**Billion lei ROL**

	2004	2005
The share of personnel expenditures in GDP	2,27%	2,47%
The share of material expenditures and services in GDP	1,70%	1,86%
The share of expenditures for subsidies in current expenditures in GDP	1,03%	1,08%
The share of expenditures for bonus in current expenditures in GDP	0,07%	0,07%
The share transfers in current expenditures in GDP	5,09%	6,04%
The share of interests related to public debt in GDP	1,71%	1,40%
The share of reserves in GDP	0,02%	0,01%

*F. The elasticity of expenditures compared to GDP**F.1. The elasticity of total expenditures compared to GDP*

$$\text{a) } \frac{\text{Total expenditures 2005} - \text{total expenditures 2004}}{\text{Total expenditures 2005}} = \frac{387.955,2 - 351.291,8}{387.955,2} = 0,095$$

$$\text{b) } \frac{\text{GDP 2005} - \text{GDP 2004}}{\text{GDP 2005}} = \frac{2.494.670 - 2.387.914}{2.494.670} = 0,043$$

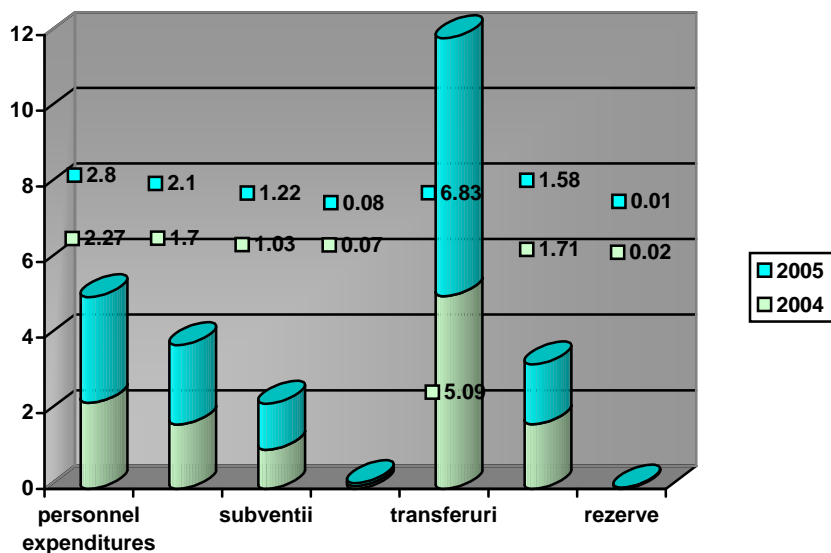
$$\text{c) } 0,095 / 0,043 = 2,209 \longrightarrow \text{there is the tendency of using in a great extent the GDP for financing the total expenditures}$$

*F.2 The variability of the current expenditure compared to GDP*

$$\text{a) } \frac{\text{Current expenditures 2005} - \text{Current expenditures 2004}}{\text{Current expenditure 2005}} = \frac{322.530,9 - 284.128,2}{322.530,9} = 0,119$$

$$\text{b) } \frac{\text{GDP 2005} - \text{GDP 2004}}{\text{GDP 2005}} = \frac{2.494.670 - 2.387.914}{2.494.670} = 0,043$$

$$\text{d) } 0,119 / 0,043 = 2,767 \longrightarrow \text{there is the tendency of using in a great extent the GDP for financing the current expenditures}$$



*F.3 The variability of the capital expenditure compared to GDP*

a)  $\frac{\text{Capital expenditure 2005} - \text{Capital expenditure 2004}}{\text{Capital expenditure 2005}} = \frac{28.837,7 - 29.235,2}{28.837,2} = -0,014$

b)  $\frac{\text{GDP 2005} - \text{GDP 2004}}{\text{GDP 2005}} = \frac{2.494.670 - 2.387.914}{2.494.670} = 0,043$

c)  $-0,014 / 0,043 = -0,326 \longrightarrow$  it expresses the tendency of restraining the proportion of capital expenditures in GDP

*F.4. The variability of granted loans compared to GDP*

a)  $\frac{\text{Granted loans 2005} - \text{granted loans 2004}}{\text{Granted loans 2005}} = \frac{129,2 - 207,7}{129,2} = -0,607$

$$\text{b) } \frac{\text{GDP 2005} - \text{GDP 2004}}{\text{GDP 2005}} = \frac{2.494.670 - 2.387.914}{2.494.670} = 0,043$$

c)  $-0,607 / 0,043 = -14,116$   $\longrightarrow$  it expresses the tendency of restraining the proportion of granted loans in GDP

*F.5. The variability of credit repayments, interest payments, commissions to credits compared to GDP*

$$\text{a) } \frac{\text{Credit repayments 2005} - \text{Credit repayments 2004}}{\text{Credit repayments 2005}} = \frac{36.457,4 - 37.400,2}{36.457,4} = -0,026$$

$$\text{b) } \frac{\text{GDP 2005} - \text{GDP 2004}}{\text{GDP 2005}} = \frac{2.494.670 - 2.387.914}{2.494.670} = 0,043$$

c)  $-0,026 / 0,043 = -0,604$   $\longrightarrow$  it expresses the tendency of restraining the proportion of credit repayments, interest payments, commissions to credits in GDP

**The correspondence between the growth of public spending and growth of gross domestic product<sup>1</sup>**

$$(387.955,2/351.291,8) / (2.494.670 / 2.387.914) = 1,104 / 1,045 = 1,056 \longrightarrow$$

it shows that gross domestic product has increased more slowly compared to expenditure, but at the same time, increased expenditure leads to an increase in GDP, depending on the value of the coefficient of the multiplication<sup>2</sup>. Obtaining such a result implies that fiscal pressure should not increase, because it diminishes the disposable income of private individuals who carry out the allocation between consumption and investment. So, expenditures exercise an effect maximum multiplier effect, when they are financed the budgetary deficit.

<sup>1</sup> Relationship of calculation is: (expenditure in 2005 / 2004 expenditure year) / (GDP year 2005 / GDP year 2004).

<sup>2</sup> The concept of a multiplier designates the effect of a exogenous variable (tax, unemployment, expenditure) on an endogenous variable (national income, GDP, disposable income, savings, investments)

#### **4. The conclusions regarding the characteristics of expenditures for the analyzed period**

- a) Personnel expenditures are increasing in 2005 with 7505.5 billion ROL; this growth is determined mainly by:
  - Full ensuring funding necessary for the payment of salaries of budgetary staff as a result of salary increases for all categories of budgetary personnel starting with 1 January 2005;
  - Court resolution that grants the wage differences to the authorities;
  - Elimination of reduction by two percentage points of the social security contributions share.
- b) Expenditures for materials and services are increasing comparing with 2005. The growth of these expenditures is influenced mostly by the:
  - Providing medicines and medical services (5075.7 billion lei);
  - To increase tariffs for the use of broadcasting stations and video and sound circuit to the Romanian Society for Broadcasting and Romanian Television Society (450.0 billion).
- c) Interest payments on public debt in 2005 with a share of 1.58% of gross domestic product going less by 0.13 percentage points to the year 2004. The decreasing tendency of the expenditures with its interest related to public debt will continue; there are factors that influence favourably:
  - The decline in interest rates on the interbank market with the consolidation of the disinflation process;
  - Using since 2000 the revenues from privatization and the recovery of non-performant banking assets for the redemption of state titles;
  - Extension of the maturity curve of financing and refinancing instruments of government internal debt which will reduce the monthly volume of refinanced titles;
  - Reducing granted loans.
- d) The expenditures with loans diminish; this reduction represents, mainly, influences in reducing the exchange rate leu/euro comparing with the one planed for 2005 budget, and also a resizing them depending on the progress of external loan agreements. The most significant reductions are located: ensuring the compliance of the commitments made by Romania in the process of accession to the European Union, the implementation of new fiscal measures adopted recently, the correlation of the general consolidated budget deficit with other macroeconomic parameters



- e) The subventions, the bonus and the transfers continue to hold the largest share of the gross domestic product, and 8.13% in 2005, going up by 1.94 percentage points comparing with 2004, due to social transfers. The increasing transfers are determined on the one hand, as **supplementing** for providing necessary funds:
- recalculation of pensions (5426.3 billion lei);
  - full payments of farmers and military pensions, allowances and other entitlements for revolutionaries (5300.5 billion lei);
  - indexing allowances for children (514.2 billion lei);

On the other hand, as **reducing** by resizing the nature of these expenditures as a result of estimating the reduction of exchange rate compared to that used in elaborating the 2005 budget;

- f) Capital expenditures for 2005 are 28837.7 billion lei diminished compared to 2004, with 397.5 billion lei, in circumstances where the capital expenditures is part of other expenditures of the general consolidated budget (transfers, loans, own revenues, external non-refundable funds).

## 5. Budget policy - debates<sup>1</sup>

The public expenditures are instruments used in the budgetary policy. They are targeted for implementing the decisions of the members of society. The used budgetary policy instruments are diverse. They serve to purchases of goods and services by institutions which implement state policy or subventions granting, perform social services, etc.; all have the mission of orienting, at the microeconomic level, those that benefit from budget appropriations adopted by budget laws, in order to provide the necessary and efficient public services, in accordance with the general interest of society. The efficiency and effectiveness of budget expenditures encompasses the modern methods of sizing expenditures as project and choosing the optimal variants.

The stress on quantity, quality and efficiency of public expenditures may be found also in the budgetary strategy, finalized in budgets – the multiannual program. They design and pursue the implementation (including the stipulations allocated

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<sup>1</sup> The source: The press conference in November – December 2004 and 2005 presented by Calin Popescu Tăriceanu, Vladescu, Ionut Popescu.

annually in the budgetary law), the observing the sustainable development implementation of the vision in the short term, with the medium and long term.

Budgetary policy for 2004 was based on the addressability of the obligatory social expenditures, protecting the priority expenditures and reducing the non-essential expenditure, which will allow **improving the stability policy of expenditures and, consequently, the effectiveness of budgetary allocations.**

**The objectives of budgetary policy** aim the following:

- **maintaining the budget deficit at a reduced level**, funded with non-inflationist estimated at 3.0% of gross domestic product;
- **improving the prioritization of public expenditures and a reconsideration of social policy** by providing social protection based on measures focused on the level of the population categories which are most disadvantaged;
- **the continuous adjustment of budgetary expenditure to real possibilities of accumulating the budget revenues** and achieving a budgetary stability;
- continuation of the budgetary programming by substantiating budget and the allocation of public funds based on programs; the programs will be targeted in priority sectors of the economy and they will contain performance goals clearly defined, with a clear positive impact on economic growth and improving the living standards of the population.

Romania has registered a strong economic growth, a deepening of the current account deficit and a slowing of the process of disinflation. The fiscal pro-cyclical policy, combined with the development of policy wages of public sector has widened the existing macroeconomic imbalances. Real GDP growth was 8.3% in 2004, reducing to 4.9% in the first half of 2005 as a result of the negative impact of flooding and a slowing rate of growth of exports.

The inflation at the end of the year fell to 9.3% in 2004 on the rapid appreciation of the national currency, but stalled in 2005 due to the increase of administered prices, international prices of energy and real wage growth by more than 13%.

Wage increases recorded during the pre-election in 2004 and they have continued in 2005, while wage increases in the private sector were generally correlated with productivity.

The degree of employment with the legal age of employment has increased by 0.4% in 2004 and the rate of employment remained at 57.7%. Unemployment rate rose from 6.8% in 2003 to 7.1% in 2004, but during 2004 it was registered a gradual decrease, reaching in the first quarter of 2005 to 5.6%.

The mix the policy has become less prudent, especially in terms of reducing taxes and strong wage growth.

Total expenditures exceeded the original budget for 2004, particularly due to salary expenditures and other current expenditures, which were higher than those set by the budget. The pre-election expenditures were in the form of important increases in pensions and wages in the public sectors, which together with a considerable increase in the minimum wage have been added the wage costs, which were already very high. Real wages have increased by more than 10% in 2004 and 13.4% in first 8 months of 2005.

A major fiscal reform was implemented in January 2005, consisting of a significant reduction of profit tax from 25% to 16% and the introduction of unique quota of income tax of 16%. Improving the tax collection, broadening the base of taxation and restrictive expenditure policy aimed at offsetting the reduction in budgetary revenue as a result of these tax reductions. The reform can contribute to increasing private investment and employment in the formal sector in the medium term. However, it generates concerns by the tendency to be pro-cyclical, aggravating the existing imbalances, and the risks that cause a decline at the already reduced level of the revenue / GDP. The measures to increase revenue and reduce expenditures decided in May and June 2005 were aimed at limiting the adverse effects, but the prudence regarding the wage policy from the public sector and the expenditure policy that has not been applied as it had been announced. There was done a budgetary consolidation although limited in the context of strong economic growth, and the public finances are fragile in Romania in reducing growth. With the possible adverse effect of fiscal reform on the revenue budget, this represents a concern regarding the fiscal position of Romania's accession to the EU. The need for budgetary financing for supporting the process of real convergence and preparation for the accession to the EU stresses, also the need to increase the budgetary revenues, in particular by improving the collection, broadening the tax base or increase the indirect taxes, and the better prioritization of expenditures in order to ensure that Romania will be ready to become a EU member.

In its periodic report it was noted that **fiscal sustainability** should be strengthened by advancing the expenditure reform and further improving income tax compliance.

*There has been recorded progress regarding the compliance in paying taxes, but the accumulation of new arrears was not stopped. You can not notice any progress in the reform of expenditure.* As part of efforts to strengthen the budgetary framework, the public finance law has been applied to elaborate the multi-annual budgets, establishing limits on budget spending for budgetary agencies and the use of budget reserve funds. These efforts were completed by continuing the process of fiscal decentralization, which increased the fiscal autonomy of local authorities regarding the allocation of revenues and expenditures, but without the simultaneous strengthening of mechanisms for control of local public finances. Romania has not set up so far medium-term expenditure in order to support the reallocation of public spending to human capital, infrastructure and administrative capacity. The public investment increased to 3.5% of GDP in 2004, but the expenses investments were limited in 2005 in an attempt to counterbalance the negative impact on the budget, exercised by the increased wages in the public sector.

For the reduction of transfers from the EU, efforts have been made in improving the growth of EU funds absorption, including through the use of incentive pay for the retention and attraction of qualified staff. The education was a priority area for spending, additional resources being provided. Caused by a fragile public pension system from the financing point of view, which is affected also by the considerable increase of pensions in 2004 for a large number of pensioners, Romania has decided to continue with the implementation of the second pillar, while limited measures have been taken to counter the pressure of increasing costs of health system. To ensure both the consistency over time and that the public finances will contribute increasingly more to increase of growth potential of the economy; there was necessary a stronger link between the budgetary implementation and a global strategy for reallocating of budgetary expenditure, including a more active role for the multi-annual budgetary framework.

The pro-cyclical effect of the reform of taxation and of wage policy in the public sector is responsible for this and they are not in line with the call in 2004 for a mix of prudent policy. Priority should be given to restoring a prudent fiscal policy, in particular implementing additional measures to permanently strengthen the

collection basis and through a wage policy of the public sector in a prudent expenditure strategy, aiming at strengthening the potential of economic growth and preparations for accession to the European Union.

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